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VIA ELECTRONIC DELIVERY

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250 E Street S.W.
Mail Stop 2–3
Washington, D.C. 20219
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Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551
Docket No. R–1430; RIN No. 7100–AD87
Docket No. R–1442; RIN No. 7100–AD87
Docket No. R–1442; RIN No. 7100–AD 87

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
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Washington, D.C. 20429
FDIC, RIN 3064–AD95
FDIC, RIN 3064–AD96
FDIC, RIN 3064–AD97

RE: Comment Letter on Proposed Risk-based Regulatory Capital Rules

Ladies and Gentlemen:

The undersigned organizations[1] are pleased to provide comments on the following three joint notices of proposed rulemaking by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation

[1] The undersigned organizations are: Building Owners and Managers Association International, International Council of Shopping Centers, National Apartment Association, National Association of Home Builders, NAIOP the Commercial Real Estate Development Association, National Association of Real Estate Investment Trusts, National Association of Realtors, National Multi Housing Council, and The Real Estate Roundtable. Further information about these organizations is provided in Appendix 1.

(the “Agencies”): (1) Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (“Basel III Numerator NPR”);[2] (2) Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements (“Standardized Approach NPR”);[3] and (3) Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule (“Advanced Approaches NPR”).[4]

Our members represent commercial and multifamily real estate borrowers as well as investors in commercial, multifamily, and single-family residential real estate (collectively, the “Real Estate Associations”). The Real Estate Associations and their members lead an industry that generates more than 20 percent of America’s gross national product, employs more than 9 million people, and produces nearly two-thirds of the taxes raised by local governments for essential public services. In the aftermath of the financial crisis, the U.S. residential, multi-family and commercial real estate sectors remain critical forces in shaping the magnitude and direction of rebuilding our economy and job recovery.

We support the Agencies’ efforts to ensure the safety and soundness of the banking system through revisions to the risk-based capital framework. At the same time, we believe that several aspects of the proposed rulemakings would have harmful effects on the availability and cost of credit to commercial, multifamily, and single-family residential real estate borrowers and on the U.S. economy in general. Given the importance of commercial, multifamily, and single-family real estate to the U.S. economy, the credit challenges currently facing real estate borrowers and investors, the fragile nature of the economy, and the continued volatility in credit and capital markets, the Real Estate Associations strongly believe that further study and analysis is necessary to appropriately craft the proposed rules to ensure a properly functioning and reliable credit market.

The Real Estate Associations therefore request that the Agencies further study the impact of the proposed rules on real estate markets and the U.S. economy prior to implementing any final rule. This study should include a comprehensive cost benefit analysis of how the proposed rules will affect real estate markets and the overall economy. This study also should include empirical analysis evaluating the alignment of the proposed risk weights with actual risk to avoid perverse lending incentives and regulatory arbitrage.

The Real Estate Associations further request that the Agencies re-propose the capital rules following these empirical studies and allow a comment period on any re-proposed rule prior to implementing a final rule. Any re-proposed capital rules should be more risk sensitive and more accurately reflect the actual risk of lending activities so that real estate borrowers have access to credit markets at fair prices. In particular, any re-proposed rule should:

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[2] Basel III Numerator NPR, 77 Fed. Reg. 52,792 (Aug. 30, 2012).

[3] Standardized Approach NPR, 77 Fed. Reg. 52,888 (Aug. 30, 2012).

[4] Advanced Approaches NPR, 77 Fed. Reg. 52,978 (Aug. 30, 2012).

- Clarify that the definition of high volatility commercial real estate ("HVCRE") does not include completed projects;

- Recognize additional forms of borrower equity, such as land, pre-leasing agreements, and contracts to purchase, in the exclusion from the definition of HVCRE;

- Tier commercial real estate ("CRE") lending based on loan-to-value ("LTV") ratio to recognize varying degrees of risk among CRE projects;

- Reduce the proposed risk weights for CRE and HVCRE loan modifications and restructurings to encourage loan modifications and restructurings that would benefit both the borrower and the bank;

- Reduce the capital burden on mortgage servicing assets ("MSAs");

- Reduce risk weights for residential mortgages to more accurately reflect the actual risk of such loans;

- Recognize private mortgage insurance ("PMI") as a source of risk mitigation;

- Reduce the credit conversion factor ("CCF") for repurchase agreements ("repo") and similar transactions that face low counterparty credit risk;

- Introduce additional risk sensitivity for corporate exposures, such as commercial lines of credit, which are critical to real estate borrowers and investors;

- Reduce the CCF for financial standby letters of credit, which are essential credit enhancements for real estate borrowers and investors during financial downturns;

- Recognize certain highly liquid mortgages as "financial collateral" to facilitate warehouse lending;

- Introduce a more risk-sensitive measure for over-the-counter ("OTC") derivatives to facilitate risk hedging for real estate borrowers and investors;

- Clarify that the definition of "securitization" does not include CRE loan syndications or guarantees;

- Exercise supervisory discretion in requiring due diligence reviews for real estate securitizations to reduce the potential that banks will not purchase new or unique securitizations;

- Cap risk-weights at equal to a dollar-for-dollar capital deduction so that certain securitizations are not penalized with a harsh 1,250 percent risk weight;

- Clarify the treatment of guaranteed multifamily mortgage-backed securities ("MBS"); and

- Modify the simplified supervisory formula approach ("SSFA") to increase risk sensitivity and reduce the risk weight burden for real estate securitizations.

These changes would address some of the problems in the proposed rules that otherwise would compel banking organizations to reduce the availability of credit, increase the cost of credit, and reduce liquidity in the real estate market. These changes are discussed in greater detail below.

I. Impact on Real Estate Borrowers

Commercial banking organizations are the primary source of credit for commercial and multifamily real estate.[5] The proposed capital rules would substantially change the existing risk-based capital framework by imposing significantly higher capital charges on real estate lending and servicing activities. Because these high capital charges have not been shown to correspond with the actual risk of such lending and servicing activities, banking organizations would unnecessarily reduce their participation in these activities and increase the cost to borrowers to compensate for the higher capital charges. As a result, borrowers would be confronted with fewer sources of credit and more expensive credit. The Agencies therefore should carefully study the effects of the proposed rules on borrowers and real estate markets to determine if the proposed changes are justified.

A. <u>Commercial Banks Are Vital to Commercial and Multifamily Real Estate Markets</u>

Commercial, multifamily, and single-family residential real estate have been pillars of the nation's economy for decades. Real estate also has played an increasing role in global capital markets through direct investment and securitization. Many private and institutional investors look to commercial real estate as an investment opportunity for their overall investment strategies due to historically strong returns and as a way to achieve a balanced and diversified portfolio. Investments are made through managed funds; direct ownership; the purchase of real estate investment trust ("REIT") stock; the purchase and trading of securities in investment markets through commercial mortgage-backed securities ("CMBS"), residential mortgage-backed securities ("RMBS"), and REITs; and institutional investment through life insurance companies, pension funds, and other government investment funds. The increased role of real estate in national and international markets has led to greater transparency, enhanced liquidity, better discipline, and more exacting scrutiny of real estate asset quality. As a result, the process for disclosing market information has become more defined, the quality of information required by both regulators and investors has improved, and the speed with which property performance information becomes available has accelerated.

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[5] *See, e.g.*, PricewaterhouseCoopers & Urban Land Institute, *Emerging Trends in Real Estate* 20 ex. 2-11 (2011).

Commercial banks are the principal source of credit for U.S. commercial and multifamily real estate[6] and also serve as a significant source of credit for CRE development and production. Although banking organizations suffered losses in the real estate market during the most recent financial downturn, losses in the commercial asset class were limited and related to the economic downturn rather than to specific structural issues associated with CRE lending and securitization structures. Increased CMBS delinquencies from a few large investments impacted relatively few investors. Subordination in the CMBS market provided stronger and more conservative underwriting, and top-tier investors found strong and safe returns. Commercial and multifamily assets rapidly re-gained their value compared to single-family real estate because the CRE market did not suffer from excess capacity.

Nonetheless, commercial real estate markets continue to recover from the most severe economic downturn since the Great Depression due in part to the shortage of credit in the economy. Credit to the sector virtually shut down in 2008 and only began to return in a limited capacity in 2010. As the largest source of credit for commercial and multifamily real estate in the United States, continued and robust commercial bank lending is an essential element of the commercial real estate industry. Yet, hopes for a broader recovery in real estate credit markets continue to be undermined by uncertainty in global credit markets and the broader economy—and further exacerbated by a lack of confidence in the regulatory climate.

Given the importance of real estate to the economy and the importance of commercial banks to the commercial and multifamily real estate lending sector, the Agencies should carefully study the impact of the proposed capital rules before implementing such significant changes across the U.S. real estate markets.

B. <u>Proposed Capital Rules Would Significantly Reduce Credit Availability and Increase the Cost of Credit</u>

The Basel III Numerator NPR would require banks to hold more capital than ever before with a more stringent definition of what qualifies as capital in a new common equity tier 1 capital ratio; increases to required minimum capital ratios; a new capital conservation buffer that would further increase the required level of those ratios; and a new supplemental leverage ratio. Further, the Standardized Approach and Advanced Approaches NPRs would impose higher risk weights for many asset classes, such as residential and commercial mortgage exposures, repos and similar transactions, and securitization exposures, which would further increase banks' required capital ratios based on their current mix of assets.

These proposed changes to the risk-based capital framework would add to the recent statutory, regulatory, and market changes to the real estate lending and servicing markets. For example, the Dodd-Frank Act will make securitization more costly through the credit risk retention[7] and ability to repay[8] requirements. The agencies implementing these requirements

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[6] *See id.*

[7] Dodd-Frank Act § 941.

[8] *Id.* § 1412.

(the Federal Reserve and the Consumer Financial Protection Bureau, respectively), may further restrict underwriting standards through regulations. Additionally, Title VII of the Dodd-Frank Act and implementing regulations by the Commodity Futures Trading Commission and Securities and Exchange Commission have overhauled the over-the-counter derivative markets, which will make hedging CRE loans and mortgage securitizations more costly.[9]

All of these statutory, regulatory and market changes, combined with the proposed capital rules, would significantly curtail real estate lending by the banking sector. In particular, the proposed rules would:

- Substantially increase the cost of bank lending to commercial, multifamily, and residential real estate borrowers due to the high capital charges on real estate loans and comparatively lower capital charges on unsecured loans;

- Exacerbate boom and bust cycles because the proposal would impose higher capital charges on modified and delinquent loans—which are already addressed separately in the regulatory regime through substantial loan loss reserve requirements—thus tying up capital during economic downturns when credit is needed the most;

- Restrict other forms of bank lending to real estate firms due to the high capital charges on repurchase agreements, lines of credit, standby letters of credit, and other off-balance sheet assets;

- Further reduce property values as fewer and fewer borrowers are able to obtain financing to purchase properties; and

- Increase interest rate risk and credit risk in the real estate sector because banks would be less willing to incur the high capital charges associated with specialized hedging transactions with real estate borrowers and investors.

C. <u>Agencies Should Study the Impact of the Proposed Rules and Re-propose with Opportunity for Comment</u>

Real estate lending is too important to real estate borrowers, and too important to the overall U.S. economy, for such sweeping changes to be made without substantially more empirical study and support. The Agencies therefore should study and evaluate the effect of the proposed rules before finalizing such substantial changes to the current risk-based capital framework. The Real Estate Associations also request the Agencies to re-propose the three NPRs following such study to allow interested parties to comment on the results of the study and any resulting changes to any re-proposed rules.

In particular, the Agencies should study the combined impact of overall higher minimum capital requirements, the new requirements for a common equity tier 1 capital ratio

[9] *See id.* Title VII.

and a supplementary leverage ratio, the narrower definition of capital, and the substantial changes to the risk-weighting of assets in the lending and borrowing industries. The regulatory burden, increased cost of credit, and decreased availability of credit simply may be too onerous relative to any potential benefit to safety and soundness to justify all of these changes. Such a study would be consistent with the Agencies' past approach to conduct impact studies prior to implementing capital changes,[10] and it would be especially necessary in this instance given the sweeping and substantial proposed changes to the numerator, denominator, and overall capital ratio.

As part of this study, the Agencies also should sponsor a series of industry forums to permit banking organizations, their customers, and other interested parties to provide further comments on the impact of the proposed rules. These forums would alert industries to potential changes to capital requirements and alert the Agencies of the potential consequences of a proposal.

The Real Estate Associations strongly urge the Agencies to re-propose the capital rules following such study and allow comment on any re-proposal. These additional steps would allow all parties—the Agencies, regulated banking organizations, and borrowers—to carefully evaluate the impact of any proposed changes and reduce the potential for unintended and negative consequences on the real estate market and U.S. economy more broadly.

II. Commercial Real Estate

The Real Estate Associations support the proposed 50 percent risk weight for pre-sold construction loans and statutory multifamily mortgages, which is consistent with the existing risk-based capital rules.[11]

We have substantial concerns, however, about the high proposed risk weights for other commercial asset classes. Underwriting commercial real estate has been appropriate and well-managed since implementation of the existing risk-based capital requirements two decades ago. The proposed capital rules do not recognize this fact, and instead impose much higher capital charges based on much higher risk weights. This mismatch between actual risk characteristics and the proposed risk weights would have significant negative effects on the CRE market, as described further below.

A. Effect of Proposed HVCRE Rules on Commercial Real Estate Lending

The Standardized Approach NPR would require banks to assign a 150 percent risk weight to a new category of HVCRE loans.[12] The proposal defines HVCRE as "a credit facility that finances or has financed the acquisition, development, or construction ("ADC") of real

[10] *See, e.g.*, Board of Governors of the Federal Reserve System, Summary Results of the Fourth Quantitative Impact Study (Feb. 24, 2006).

[11] *See* Standardized Approach NPR, 77 Fed. Reg. 52,900–01.

[12] *Id.* 52,951 (adding § __.32(j)).

property."[13] A bank would be permitted to treat an ADC loan as a regular CRE loan subject to a 100 percent risk weight *only* if the facility finances:

> (1) one- to four- family residential properties; or
>
> (2) commercial real estate projects in which:
>
> (i) the loan-to-value ratio is less than or equal to the applicable maximum supervisory loan-to-value ratio in the [AGENCY]'s real estate lending standards . . . ;
>
> (ii) the borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15 percent of the real estate's appraised 'as completed' value; and
>
> (iii) the borrower contributed the amount of capital required in (2)(ii) of this definition before the [BANK] advances funds under the credit facility, and the capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project throughout the life of the project," that is, until the facility is converted to permanent financing or is sold or paid in full.[14] Moreover, permanent financing by the bank must conform to the bank's underwriting criteria for long-term mortgage loans.[15]

This proposed definition of HVCRE is too broad, and the exception from HVCRE treatment is far too narrow. The proposed treatment of HVCRE does not recognize many current practices that reduce the risk of an ADC loan. For example, some borrowers provide land rather than cash for a CRE loan. These ADC loans would be subject to a 150 percent risk weight under the Standardized Approach NPR, even though such a loan would be less risky due to the borrower's investment in the property. Similarly, the proposed rule does not recognize pre-leasing tenant agreements, even though such agreements guarantee income for the property and therefore reduce the risk of loss.

In response to the proposed changes, banks would substantially change their current lending practices and reduce the amount of available CRE credit in order to avoid the high capital charges associated with HVCRE. In particular, banks would:

- Lower LTV ratios and increase the amount of required equity to 15 percent of the as-completed value (rather than of construction costs or other reference);

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[13] Basel III Numerator NPR, 77 Fed. Reg. 52,852 (adding § __.2).

[14] *Id.*

[15] *Id.*

- Require cash equity rather than equity attributable to a property's appraised value;
- Require this minimum 15 percent cash equity before disbursing loan proceeds;
- Impose financial covenants on a borrower to maintain a minimum amount of equity in the project during the term of the loan, including substantial limits to the right to make distributions even upon completion of the project;
- Increase emphasis on take-out commitments, with deadlines to achieve take-out financing preceding maturity by many months (so as to reclassify the loan as non-HVCRE as soon as possible);
- Increase scrutiny of construction deadlines and lease-up thresholds (to ensure greater certainty with respect to take-out financing);
- Shorten durations and provide fewer mini-perm loans (due to the methodology for determining when the minimum equity requirements end); and
- Engage in more frequent syndication of construction loans so that the originating bank removes portions of the HVCRE loans from its balance sheet, with a corresponding increase in loan administration and other fees to counteract the lost profits from the syndication.

To avoid these unintended consequences, the Real Estate Associations request the Agencies to make the following changes to the treatment of CRE and HVCRE in any re-proposed rule.

B. <u>Clarify Definition of HVCRE</u>

The proposal defines HVCRE as "a credit facility that finances *or has financed* the acquisition, development, or construction ("ADC") of real property."[16] This definition is unclear and could be read to encompass an ADC loan through the entire life of the loan, including after the property has been completed and tenants occupy the building. Banks would rarely, if ever, make ADC loans if they would be required to assign the high 150 percent risk weight to the property through the entire life of the loan.

The Real Estate Associations seek clarification that the proposed definition of HVCRE does not include completed, income-earning properties. This clarified definition of HVCRE would be consistent with the actual risk profile of an ADC property: although ADC loan exposures present unique risks during the development and construction stages, these risks decrease once the underlying property has been completed and is ready for tenant use. At that point, expenditures shift from construction costs to tenant improvements and building operations, and risks shift from development risk to general commercial, cash flow risk. Consistent with this changed risk profile, banks should be permitted to re-evaluate ADC loans after the underlying

[16] *Id.* (emphasis added).

property has been completed and treat such loans as general corporate exposures rather than as higher risk-weighted HVCRE exposures.

C. <u>Modify the Requirement for Borrower-Contributed Capital</u>

The requirement in clause (2)(ii)[17] that a borrower contribute cash or unencumbered readily marketable assets to be exempted from the proposed definition of HVCRE is too narrow. In practice, commercial borrowers contribute to an ADC project in a variety of ways that reduce the risk of the loan. The proposal does not recognize these types of borrower contributions, even though such loans are less risky due to the borrower's investment in the property. The Real Estate Associations recommend several changes to the types of borrower-contributed capital that would qualify for the exception from the definition of HVCRE.

First, any re-proposed rule should recognize "other acceptable collateral" as defined in the Agencies' real estate lending standards as capital contributed by the borrower for purposes of clause (2)(ii) of the exclusion from HVCRE. Other acceptable collateral reduces a banking organization's risk in the project and allows creditworthy borrowers with low levels of readily available cash to obtain credit. Moreover, this approach would be consistent with the reference to the real estate lending standards in clause (2)(i) of the HVCRE exclusion and with banks' actual underwriting practices.

Second, any re-proposed rule should recognize the value of land contributed by the borrower. Like borrower contributed cash, borrower contributed land increases the borrower's equity in the investment, reduces the loan amount, and reduces the banking organization's risk in the project. As with other acceptable collateral, recognition of borrower-contributed land would allow creditworthy borrowers that have low levels of readily available cash to finance projects that would grow the economy.

Third, banking organizations should be able to consider a contract to purchase the property or a pre-leasing contract as borrower contributed capital. Both types of contracts guarantee future income for the borrower, thereby reducing repayment risk and default risk for the banking organization. Moreover, recognition of contracts to purchase and pre-leasing contracts would permit creditworthy borrowers to develop useful projects and allow investors and businesses to buy into such projects at a low cost in their early stages.

Fourth, any re-proposed rule should recognize property that is contributed at below fair market value for purposes of clause (2)(ii). In some instances, a borrower will enter into a contract with a land owner to have the land contributed to the project at below fair market value. Property that is contributed at below fair market value reduces development costs of the loan and increases the percentage of a borrower's equity in the project. Depending on the contract, the borrower would repay the property owner in a variety of ways, such as by granting the property owner an equity interest in the project or a percentage of profits upon sale. The property owner, rather than the lender bank, would thus assume some of the risk of the project. Despite the reduced risk to the bank and the benefit to the borrower, banks may be reluctant to

[17] *Id.*

fund such projects if they are classified as HVCRE due to the high risk weight and the regulatory stigma of an HVCRE project. To avoid this result, the Real Estate Associations strongly urge the Agencies to recognize the difference between the fair market value of the property and its contributed price as capital that is contributed by the borrower.

Finally, any re-proposed rule should calculate borrower-contributed capital as a percentage of the estimated costs of the project rather than the "as completed" value. Clause (2)(ii) requires borrowers to contribute capital "of at least 15 percent of the real estate's appraised 'as completed' value."[18] This proposed approach would be difficult to implement because the "as completed" value could not be appraised until the project is completed. This would result in regulatory uncertainty and possible over-collateralization by the borrower. By contrast, both the bank and the borrower estimate development and project costs at the beginning of the project—the same time as when the borrower contributes capital. The Agencies therefore should replace the clause "the real estate's appraised 'as completed' value" in clause (2)(ii) of this definition to read "the estimated total development costs through completion of construction and stabilization as approved by the lender." Replacing "as completed" value with the "estimated costs" standard is both more conservative and more practical to implement.

D. Exclude Housing Projects Financed by LIHTC from Definition of HVCRE

The proposal excludes one- to four- family residential properties and certain CRE projects from the definition of HVCRE.[19] Properties financed by the Low Income Housing Tax Credit ("LIHTC") Program similarly should be excluded from the definition of HVCRE because the high 150 percent risk weight for HVCRE overstates the risk of LIHTC projects. Moreover, the punitive risk weight would directly undermine longstanding public policy in favor of such projects.

The LIHTC is an indirect federal subsidy used to finance the development of affordable rental housing for low-income households. LIHTC awards require that property owners accept and maintain ongoing restrictions on tenant rental rates. Those rental restrictions reduce projected net operating incomes, and therefore reduce the appraised values of those projects. Lower appraised values increase LTV ratios and would drive a higher percentage of these projects into the proposed HVCRE category. Additionally, borrower-contributed capital for these projects often include "soft pay" subordinated debt from public sector sources (*i.e.*, debt repayable only to the extent of excess cash flow, if any) or donated land from public sector sources—neither of which complies with the proposed definition of upfront equity for purposes of clause (2)(ii) of the exemption from HVCRE.

LIHTC projects should not be treated as HVCRE exposures. These projects pose little market risk, and historic performance patterns have not been volatile. The same downward pressure on rent and property values makes such properties attractive for renters. Additionally, many LIHTC projects have pre-committed, permanent take-out financing committed up front to

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[18] *Id.*

[19] *Id.*

mitigate repayment risk. Moreover, other federal statutes and regulations, such as the Community Reinvestment Act, encourage use of the LIHTC Program to promote affordable, low-income housing. By contrast, the proposed HVCRE rules discourage the use of LIHTC, or at the very least, increase the cost of such projects.

In light of these characteristics, the Real Estate Associations request the Agencies exclude LIHTC projects from the definition of HVCRE. A 100 percent risk weight is more appropriate given the policy objectives in favor of LIHTC projects and the low risk profile of such projects. This change also would be consistent with the proposed treatment of community development equity exposures at a 100 percent risk weight.[20]

E. Tier CRE and HVCRE Risk Weights Based on LTV Ratio

The Standardized Approach NPR assigns a flat 100 percent risk weight to all CRE exposures that are not statutory multifamily mortgages and not HVCRE loans.[21] Similarly, the proposal applies a flat 150 percent risk weight to all HVCRE loans, regardless of the LTV ratio. This proposed approach fails to recognize the different degrees of risk among CRE loans: just as residential mortgages present varying degrees of risk depending on LTV ratios, so too do CRE loans.[22] The Real Estate Associations therefore strongly urge the Agencies to conduct an empirical study to align any proposed risk weight with the actual risk of CRE projects, and to tier such risk weights accordingly.

Failure to properly calibrate risk weights would result in regulatory arbitrage, riskier CRE projects, and a shortage of credit for the most creditworthy borrowers. That is, if all CRE loans receive the same 100 percent risk weight, then banks would have an incentive to lend to the riskier borrowers within that group to earn a higher return. Similarly, banks would have an incentive to lend to the riskier borrowers within the flat 150 percent HVCRE risk weight bucket. To avoid this perverse result, any re-proposed rule should include additional risk sensitivity within the CRE and HVCRE buckets by assigning risk weights tiers according to the LTV ratio.

F. Modified and Past Due HVCRE Loans

The Standardized Approach NPR does not provide specific rules for modified or restructured CRE loans. Based on a plain text reading of the NPR, a past due HVCRE loan that is not guaranteed and not secured would receive a 150 percent risk weight, regardless of whether or not it was modified or restructured.

This proposed approach is problematic because HVCRE loans would receive the same 150 percent risk weight whether they are delinquent or performing. Banks therefore would

[20] *See* Standardized Approach NPR, 77 Fed. Reg. 52, 966 (adding § __52(b)(3)(i)).

[21] *See id.* at 52,898.

[22] For example, the Comptroller of the Currency recently stated that HVCRE is "an area where higher risk and higher capital should go together." Thomas J. Curry, Comptroller of the Currency, Remarks Before the American Bankers Association (Oct. 15, 2012). By the same token, lower risk and lower capital also should go together.

not have an incentive to modify or restructure loans when borrowers are struggling—usually during an economic downturn—even though a modification would be better for the borrower and for the bank. This approach is incongruous with the actual risk profile of such loans: no matter how risky the loan structure, a performing, income-producing loan is less risky than a delinquent one and should receive a correspondingly lower risk weight. Similarly, modified or restructured loans should receive a lower risk weight than delinquent loans because they reduce the risk of borrower default and help commercial property owners stay in business.

The Real Estate Associations therefore urge the Agencies to reduce the risk weight applicable to HVCRE and modified HVCRE loans so that banks have incentives to work with borrowers to prevent default. Such an approach would also more accurately reflect the actual risk profile of modified loans.

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Due to these potentially detrimental effects on the commercial real estate industry, the Real Estate Associations strongly urge the Agencies to further study the effects of the proposed CRE and HVCRE rules before implementing them.

III. Mortgage Servicing Assets

The Basel III Numerator NPR would provide limited recognition to mortgage servicing assets ("MSAs") when calculating common equity tier 1 ("CET1") capital. Under the proposal, residential and commercial MSAs must be deducted from CET1 to the extent that: (1) such assets exceed 10 percent of CET1; *and* (2) such assets, together with deferred tax assets ("DTAs") and significant common equity investments in the capital of financial institutions, collectively exceed 15 percent of CET1.[23] In addition to these deductions, the Basel III Numerator NPR would impose a 10 percent haircut on the fair market value of readily marketable MSAs that a bank may include in regulatory capital, as set forth in section 475 of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA").[24] Both of these changes reduce the capital available to meet a bank's minimum required capital ratio. Additionally, the Standardized Approach NPR would impose a 250 percent risk weight on MSAs not deducted from CET1, which would further decrease a bank's capital ratio.[25] These changes represent a significant deviation from the current treatment of MSAs under the existing general risk-based capital rules.

Any one of these changes would significantly reduce bank involvement in the mortgage servicing market and real estate markets more generally. The cumulative effect of the 10 percent and 15 percent CET1 deductions, the 10 percent haircut required by FDICIA, and the 250 percent risk weight together will be even more dramatic:

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[23] *See* Basel III Numerator NPR, 77 Fed. Reg. 52,863 (adding § __.22(d)).

[24] *See id.* at 52,863 (adding § __.22(d)(3)).

[25] *See* Standardized Approach NPR, 77 Fed. Reg. 52,951 (adding § __.32(l)(4)).

- Mortgage servicing would become more expensive as banks pass higher capital and compliance costs on to borrowers;

- The increased capital charge associated with MSAs will make them less desirable and reduce the value of MSAs;

- Banks will look to other asset strategies with lower capital charges to achieve desired returns, further constricting real estate lending; and

- Banking organizations and their borrowers will be deprived of a principle source of the ongoing bank-borrower relationship.

Moreover, these dramatic changes to the treatment of MSAs is unwarranted because banking organizations generally realize the value of MSAs. Unlike other intangible assets, such as equity interests in unconsolidated financial institutions and DTAs, MSAs have contractual cash flows that are nearly always paid. Servicing fees on Fannie Mae and Freddie Mac MBS are paid directly to the servicer; servicing fees on Ginnie Mae and most private label single family MBS are paid at the top of the cash flow waterfall; and servicing fees on most commercial and multifamily loans are paid. MSAs also have little prepayment risk: banks have demonstrated the ability to effectively hedge against prepayment risk, and commercial MSAs generally have little prepayment risk due to the contractual terms of such loans and the increased servicing fees for defaulted commercial mortgages. In addition, unlike other intangible assets, MSAs are valuable to third parties, are highly liquid, and can be sold in the open market even when the institution holding them is in distress.

The proposed treatment of MSAs is inappropriate given the differences between MSAs and other intangible assets, and given the detrimental effect on the bank-borrower relationship. The Real Estate Associations strongly urge the Agencies to carefully study the impact of the proposed changes on MSA and real estate markets prior to implementing any changes.

IV. Residential Mortgages

The Real Estate Associations have substantial concerns about the proposed treatment of residential mortgages. In particular, we believe that the proposed mortgage categories and the proposed failure to recognize any private mortgage insurance (“PMI”) would significantly reduce the amount of credit available to borrowers, substantially change the types of mortgages available, and depress an already weak residential real estate market.

A. Residential Mortgage Categories

The Real Estate Associations recognize that distortions in the residential mortgage market contributed significantly to the recent financial crisis. However, the proposed mortgage categories and risk weights in the Standardized Approach NPR overcorrect for these problems at the expense of borrowers, investors, and the U.S. economy more generally.

The Standardized Approach NPR would require banks to assign risk weights to residential mortgage exposures based on (1) whether the mortgage is a “plain vanilla,” category

1 mortgage or a category 2 mortgage, and (2) the loan-to-value ("LTV") ratio of the mortgage. Category 1 risk weights vary from 35 to 100 percent depending on LTV ratio, and category 2 risk weights vary from 100 to 200 percent depending on LTV ratio. The Standardized Approach NPR provides no empirical evidence—none—to support the substantially higher risk weights for category 2 mortgages. Instead, the preamble simply states that category 2 mortgages "generally are of higher risk" whereas category 1 mortgages "reflect those underwriting and product features that have demonstrated a lower risk of default . . . through supervisory experience and observations from the recent foreclosure crisis."[26] The Real Estate Associations submit that it is wholly inappropriate to base the kinds of sweeping changes proposed in the NPRs, described below, solely on such conclusory, subjective, and unexplained "experience and observations."

The proposed definition for category 1 mortgages is too narrow and broadly sweeps many low-risk, prudently underwritten mortgages into category 2. Although some of the proposed category 2 mortgages, such as teaser-rate adjustable rate mortgages ("ARMs") and negative amortization loans, caused enormous losses during the crisis, others performed well because they were prudently underwritten and appropriately structured for particular types of borrowers. Rather than encourage such prudently underwritten, appropriately structured mortgages, the Standardized Approach NPR penalizes all but the most "plain vanilla," first-lien mortgages.

This proposed two-category approach would substantially shrink the amount of credit available to borrowers who do not fit the "plain vanilla" mold. Banks will be more reluctant to lend to such borrowers given the high capital charge associated with category 2 mortgages, and they will substantially increase the cost of borrowing to compensate for the higher capital charge when they do lend. Additionally, some banks may eliminate certain mortgage products entirely from their portfolios. For example, the Standardized Approach NPR generally would treat home equity lines of credit ("HELOCs") as category 2 loans with risk weights ranging from 100 to 200 percent. By contrast, the Standardized Approach NPR would assign a 100 percent risk weight to general unsecured loans, such as credit cards. Given the significant risk weight differences between these similar products, banks may rationally prefer to extend unsecured loans over HELOCs—even though the risk of a prudently underwritten loan that is secured by real estate is plainly safer than a prudently underwritten loan that has no such security.

In addition to these proposed capital requirements for residential mortgages, Congress mandated a series of new and stricter real estate lending standards. For example, the Dodd-Frank Act requires stricter underwriting standards under the "qualified mortgage" and "qualified residential mortgage" rules. These rules further limit the types of residential mortgage loans banks will make to consumers, and therefore further constrict credit in the residential housing market. Moreover, the layering of the proposed capital rules on top of these substantively tightened standards will further increase compliance costs for banks, and therefore further increase the costs of credit for consumers. The cumulative impact of all these changes would be harmful during any normal economic period, and would be especially devastating now when the housing market and economy are slowly recovering from a severe recession.

[26] *Id.* at 52,898.

The Real Estate Associations therefore request that, before finalizing any Standardized Approach Rule, the Agencies conduct an in-depth study that estimates the quantitative effects of the Standardized Approach NPR on the residential mortgage market and the U.S. economy more generally, especially in light of the additional changes to bank capital requirements and underwriting standards. Indeed, since we believe that any such study will demonstrate the need to make substantial changes to the Standardized Approach NPR before it becomes final, we further request that the rule be re-proposed to allow for further public comment before it becomes final.

B. Private Mortgage Insurance

In a stark departure from the current risk-based capital rules, the Standardized Approach NPR would not permit banks to recognize *any* private mortgage insurance ("PMI") to offset the loan value of the LTV ratio at either the individual or pool-wide level. While there have been issues with the full recognition of all PMI as a risk mitigant in the existing rules, the total swing of the pendulum to recognize *no* mitigating effect of PMI is plainly excessive. Despite recent problems, PMI can and does reduce the risk of loss on a broad range of mortgages, yet banks would not receive a corresponding capital benefit for any of that loss mitigation.

This proposed change would therefore further increase the capital charge on residential mortgage loans, and therefore further shrink the availability of credit and increase the cost of credit. These effects would disproportionately impact borrowers who cannot afford to pay 20 percent down and rely on PMI to become homeowners. The Real Estate Associations therefore strongly urge the Agencies to recognize PMI in any re-proposed rule.

V. Repurchase Agreements

Under the existing general risk-based capital rules, a bank is required to hold capital for on-balance sheet exposures that arise from a repo transaction. The Standardized Approach NPR substantially changes these rules and would require a bank to hold capital for off-balance sheet repos by applying a 100 percent CCF to such exposures.[27] The Agencies reasoned that the increased capital requirement is necessary because "a banking organization faces counterparty credit risk on a repo-style transaction, regardless of whether the transaction generates an on-balance sheet exposure."[28]

REITs and independent mortgage bankers rely on the repo market to fund some of their activities. The proposed capital charge for all off-balance sheet exposures to repos would substantially reduce the number of repo transactions banks make and substantially increase the costs of repos for real estate firms.

The Real Estate Associations strongly urge the Agencies to maintain the existing treatment of repos in any re-proposed rule. The proposed treatment of off-balance sheet repos is

[27] *Id.* at 52,902.

[28] *Id.*

unwarranted because it overstates the counterparty credit risk of the exposure. In a repurchase agreement, one party sells assets or securities to another and agrees to repurchase them on a set date at a set price. The buyer does not merely acquire a security interest in the asset, but actually owns and holds title to the asset. Thus, the primary risk to the lender is the value of the underlying assets, not the counterparty.

Given that the proposed increase in capital charges for off-balance sheet exposures is intended to account for counterparty credit risk, it would be inappropriate to require additional capital for off-balance sheet exposures to bilateral repo transactions where there is virtually no counterparty risk. The Real Estate Associations therefore respectfully request the Agencies to maintain the current capital treatment rather than adopt the proposed rule for bilateral repo transactions.

VI. Commercial Lines of Credit

Real estate firms and investors rely on commercial lines of credit to fund their day-to-day business. The Standardized Approach NPR would require banks to assign a 100 percent risk weight to commercial lines of credit, and a CCF of up to 100 percent for certain unfunded portions of a line of credit. The Real Estate Associations have substantial concerns with the proposed treatment of commercial lines of credit.

The Real Estate Associations cannot overstate the importance of credit lines and letters of credit to their businesses. Bank credit lines have been a life-line in the CRE sector, enabling real estate borrowers and investors, including REITs, to finance new investments, weather unfavorable economic conditions, and avoid or limit using public markets at unfavorable times. Because bank financing often involves a long term credit relationship, banks better understand the borrower's true risk characteristics and credit quality and help them withstand economic downturns. For example, commercial and multifamily real estate firms, both public and private, harnessed liquidity from credit lines during the crisis and emerged able to focus on growing their business during the recovery. In periods of less economic stress, credit lines enable REITs and other real estate firms to react quickly and advantageously to market opportunities for acquisitions and other investments, and to finance new construction and property improvements.

Moreover, data demonstrate that REITs and other real estate firms did not, by and large, convert unsecured credit lines into secured credit lines following the financial crisis. Rather, as REITs and other firms emerged from the crisis, these lines were generally paid down and pared back.[29] The Real Estate Associations are concerned that the proposed treatment of these lines of credit will curtail their availability and increase their cost during economic downturns when credit is needed the most. Any re-proposed rule should tier corporate exposure risk weights to recognize differences in risk and reduce the CCF for standby letters of credit.

[29] *See, e.g.*, Fitch Ratings, *U.S. REITs Renewal Terms for Lines of Credit Improving* (Oct. 6, 2011).

A. Increase Risk Sensitivity for Corporate Exposures

The Standardized Approach NPR would assign a 100 percent risk weight to all commercial lines of credit as a corporate exposure. As discussed above in section II.E, a flat, 100 percent risk weight for all corporate exposures is unwarranted because it fails to address the varying degrees of risk within the general corporate asset class. Given the flat 100 percent risk weight, banks would have an incentive to lend to riskier borrowers at a higher interest rate over more creditworthy borrowers at a lower interest rate. This result would increase overall risk in the system and penalize higher credit-quality borrowers. U.S. and international bank regulators have long criticized these regulatory arbitrage problems, and the Agencies appear to share this concern in the Standardized Approach NPR. The Agencies noted that they "evaluated a number of alternatives to credit ratings to provide a more granular risk weight treatment for corporate exposures," but "each of these alternatives was viewed as either having significant drawbacks, being too operationally complex, or as not being sufficiently developed to be proposed in the NPR."[30]

Rather than retain this fundamentally flawed system, the Real Estate Associations strongly recommend that the Agencies conduct an impact study and other empirical analysis to introduce additional risk sensitivity into the treatment of corporate exposures and commercial lines of credit. The recommended impact study and additional comment period would provide the time and data necessary to properly calibrate the varying risk weights for corporate exposures, and would more appropriately align the cost of credit for borrowers with the capital charge for banks.

B. Reduce the CCF for Standby Letters of Credit

The Standardized Approach NPR also would assign a 100 percent CCF to financial standby letters of credit. The Real Estate Associations strongly believe that this 100 percent CCF overstates the risk of such credit, and accordingly, limits the amount of credit available to creditworthy borrowers.

Like other standby letters of credit, a financial standby letter of credit is contingent on a default event. The default event occurrence rate is far less than 100 percent, yet the 100 percent CCF assumes a 100 percent exposure. Although the Real Estate Associations recognize that financial standby letters of credit and other unfunded portions of a line of credit present some risk, the 100 percent CCF does not correspond with the actual risk of such credit and is far too high.

Real estate firms frequently use standby letters of credit to assure performance in real estate transactions. As a result of the capital charges on these unused lines of credit, banks would be less willing to extend these types of credit in the first instance and would charge more for such credit to compensate for the higher capital charge. Without financial standby letters of credit to enhance their credit, borrowers might be faced with substantially higher credit and transaction costs in their day-to-day business. The Real Estate Associations therefore request

[30] Standardized Approach NPR, 77 Fed. Reg. 52,898.

that any re-proposed rule reduce the CCF applicable to financial standby letters of credit to better reflect the actual risk of such exposures.

VII. Recognize Fannie Mae, Freddie Mac, Ginnie Mae, FHA, VA, and USDA Mortgages as Financial Collateral

The Real Estate Associations appreciate that the proposed definition of "financial collateral" would encompass an expanded range of financial collateral.[31] In addition, we believe that conforming Fannie Mae, Freddie Mac, Ginnie Mae, Federal Housing Administration ("FHA"), Veteran's Administration ("VA"), and United States Department of Agriculture ("USDA") mortgages also should be treated as "financial collateral" due to the liquid market for such assets. This recognition is especially important in the context of warehouse lines of credit.

Warehouse lines of credit are short-term revolving facilities that fund a lender's inventory from the closing table to sale in the secondary market. The mortgage note is used as collateral or as the negotiable instrument that supports the interim financing until the mortgage is sold and delivered to the permanent investor, at which time the initial advance of the funds from the warehouse provider is repaid. This business model depends on highly liquid, pre-sold underlying mortgages as collateral. The collateral pool for a warehouse line most frequently comprises mortgages or MBS that have been pre-committed for sale or delivery to the FHA, VA, USDA, Fannie Mae, Freddie Mac, or Ginnie Mae. These mortgages are highly liquid, have stable prices, and are expected to be paid off by sale into the secondary market anywhere from five to 90 days. Historically, the average turn-time is 15 days.

Commercial banks support this mortgage securitization process by providing the warehouse credit facilities to finance loans that are originated and sold to Fannie Mae and Freddie Mac multifamily programs, or insured by the FHA prior to securitization through Ginnie Mae or a private institution. In fact, warehouse lending is one of the primary ways that commercial banks finance loans sold to government-sponsored multi-family programs. Warehouse lending also provides the liquidity necessary to fund mortgage closings for independent banks.

Given the importance of warehouse lending to multifamily residential real estate borrowers and investors, and given the importance of highly liquid collateral to such facilities, the Real Estate Associations strongly believe that conforming Freddie Mac, Fannie Mae, Ginnie Mae, FHA, VA, and USDA mortgages should be included in the definition of financial collateral. These mortgages should be deemed collateral because they are readily marketable, uniquely liquid, and recognized by the market as low risk collateral. Failure to recognize such mortgages as financial collateral could have a detrimental impact on mortgage origination and securitization, thereby further reducing the availability of credit for borrowers.

[31] *See id.* at 52,909.

VIII. Over-the-Counter Derivatives

The Agencies generally propose to retain the same treatment of over-the-counter ("OTC") derivatives as is provided under the current general risk-based capital rules. This approach is similar to the existing exposure method ("CEM") first developed in 1988 as part of the original Basel Accord. The CEM remains a rudimentary method that lacks the risk sensitivity necessary to calculate credit exposure from OTC derivatives. As a result, the CEM greatly overstates the exposure amount of OTC derivatives. For example, the CEM extrapolates from current mark-to-market values to future mark-to-market values. Extrapolation may be a useful predictive tool when there are many repeated transactions between two parties over time, but this is only true of the largest banks and central counterparties. It is far less effective for individualized hedging transactions, such as between banks and real estate firms.

The existing general risk-based capital rules mitigate these concerns by capping OTC derivative risk weights at 50 percent. However, the Agencies propose to remove the 50 percent risk weight cap in the Standardized Approach NPR, reasoning that "the types of counterparties acceptable to participants have expanded to include counterparties that merit a risk weight greater than 50 percent."[32]

Private investors, developers, and other real estate owners use derivatives as a tool to manage interest rate risk and volatility. For example, as part of the development process, interest rate caps and swaps are critical to manage the flow of funds and investment and development outlays. Investors also commonly use derivatives in acquisition transactions to make improvements to the underlying asset during the initial ownership period. Thus, in the real estate context, firms use of swaps and other derivatives for risk management purposes rather than for core investment or business purposes.

Importantly, direct bank to borrower swaps are most appropriate in this context because they allow borrowers the flexibility to tailor their hedging strategies to a particular real estate development deal. In terms of acquisition transactions, swaps play a vital role in the borrower's ability to address deal-specific interest rate management strategies. Because every real estate acquisition deal is unique, this individualized hedging strategy allows an investor or property owner to minimize risks associated with that particular transaction and also with its overall portfolio. Moreover, banks are typically the lender on the development or construction loan and, as such, are best suited to understand the loan parameters and risks of the project.

The proposed rules penalize these types of specialized OTC derivative transactions that reduce interest rate risk because the CEM significantly overstates the risk of such transactions. This overstatement would be exacerbated by the proposed removal of the 50 percent risk weight cap. The Real Estate Associations are concerned that the risk insensitivity of the CEM for OTC transactions, combined with the proposed preferential treatment for cleared transactions,[33] will cause banks to shift away from these individualized derivative transactions.

[32] *Id.* at 52,904.

[33] *See id.* at 52,905.

Borrowers would be deprived of their lending bank's expertise and familiarity with the loan to craft the appropriate hedge strategy.

To avoid introducing more risk into the real estate sector, the Real Estate Associations urge the Agencies to adopt a more risk sensitive approach to calculate the exposure amount for OTC derivatives.[34] At the very least, the Real Estate Associations urge the Agencies to reinstate the 50 percent risk weight cap in a re-proposed rule to limit the adverse effects caused by the proposed CEM.

IX. Securitizations

The capital proposals would introduce sweeping changes to the existing securitization framework that would have dramatic effects on the MBS business. Overall, the proposals would include a broad range of tranched transactions within the definition of securitizations, impose substantial data collection requirements on banks and borrowers, and significantly increase the amount of capital a bank would be required to hold against most securitization exposures. Together, these changes would substantially shrink and reduce the value of the MBS market. Because MBS investors indirectly lend to borrowers, the proposed securitization rules would further shrink the availability of credit in the real estate sector. For example, CMBS represent the second largest source of credit for commercial real estate, after commercial banks.[35] The CMBS vehicle is an important source of "take-out" financing for borrowers to repay commercial bank ADC loans. It is, therefore, important to maintain securitization as a reliable source of credit to the real estate sector.

A. Definition of Securitization

The Standardized Approach NPR states that the proposed "securitization framework is designed to address the tranching of the credit risk of financial exposures and is not designed, for example, to apply to tranched credit exposures to commercial or industrial companies or nonfinancial assets."[36] The Real Estate Associations request confirmation that the treatment of securitization exposures would not encompass real estate loan syndications.

Additionally, the Real Estate Associations seek confirmation that limited guarantees of commercial and industrial ("C&I") loans and CRE loans would not be treated as traditional or synthetic securitizations. Both the definition of "traditional securitization" and "synthetic securitization" require that "[a]ll or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities)."[37] Although a commercial loan to an operating company or real estate project could have tranched

[34] Other trade organizations have suggested, for example, the internal models methodology or the simple value-at-risk approach.

[35] *See, e.g.*, PricewaterhouseCoopers & Urban Land Institute, *Emerging Trends in Real Estate* 20 ex. 2-11 (2011).

[36] Standardized Approach NPR, 77 Fed. Reg. 52,914.

[37] Basel III Numerator NPR, 77 Fed. Reg. 52,856.

credit risk, the underlying asset in such a transaction is real estate, an operating company, or other non-financial assets, and not financial exposures. Limited guarantees of C&I and CRE loans therefore should not be treated as securitizations under any re-proposed rule.

B. Due Diligence Requirements

The Standardized Approach NPR requires banks to demonstrate "a comprehensive understanding of the features of a securitization exposure."[38] This analysis would consider the structural features of the securitization; relevant information regarding the performance of the underlying credit exposure; relevant market data; and performance information on the underlying securitization exposure for re-securitization exposures.[39]

The Real Estate Associations appreciate that a bank should understand an asset before it purchases it. However, the proposed due diligence requirements would impose a substantial burden on borrowers and originators to provide the data necessary for banks to conduct the due diligence analysis. In many instances, such data might not even be available. For example, relevant market data, such as bid-ask spread and historic price volatility, simply are not available for new issuances. Banks would be less willing to purchase securitizations in such instances, further restricting the amount of credit available to borrowers. The Real Estate Associations therefore urge the Agencies to use supervisory discretion when determining whether a bank meets its due diligence requirements to account for the burden on borrowers of obtaining such data.

C. Maximum Risk Weight Should Not Exceed the Equivalent of a Dollar-for-Dollar Capital Deduction

The Standardized Approach NPR assigns a 1,250 percent risk weight to certain securitization exposures, including those for which a bank does not meet its due diligence obligations. Under the existing 8 percent total minimum capital requirement, a 1,250 percent risk weight is equal to a dollar-for-dollar capital deduction. The capital conservation buffer in the proposed Basel III Numerator NPR effectively raises the total minimum capital requirement to 10.5 percent. As a result, a 1,250 percent risk weight would result in a *greater than* dollar-for-dollar capital charge for that asset. This risk weight thus assumes that a bank would incur losses greater than the full amount of the bank's investment in the asset.

Whether formulated as a capital deduction or a risk weight, a banking organization should never be required to assume that it will suffer a loss greater than the amount of its investment. If adopted, banking organizations would rarely, if ever, invest in exposures with a 1,250 percent risk weight. This would present a substantial problem for borrowers that could not provide the relevant data for the due diligence determination or SSFA calculation. Any re-proposed rule therefore should cap the maximum risk weight applicable to an exposure at the equivalent amount of a full capital deduction.

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[38] Standardized Approach NPR, 77 Fed. Reg. 52,915.

[39] *Id.* at 52,962 (adding § __.41(c)(2)(i)).

D. Treatment of Fannie Mae and Freddie Mac Multifamily MBS

The Real Estate Associations strongly support the proposed 20 percent risk weight for multifamily MBS that are issued and guaranteed by Fannie Mae and Freddie Mac.[40] We also strongly support the "substitution approach" that assigns a 20 percent risk-weight tranches of multifamily MBS issued by a third party but guaranteed by Fannie Mae and Freddie Mac.[41]

However, the Agencies should clarify that tranches of MBS that are not guaranteed by Fannie Mae or Freddie Mac should be treated separately from the multifamily MBS tranches guaranteed by Fannie Mae and Freddie Mac. Otherwise, the non-guaranteed tranches may "taint" the guaranteed multifamily CMBS tranches and trigger a higher overall risk weight for the guaranteed tranches. With this clarification, the Real Estate Associations supports the risk-weight treatment of Fannie Mae and Freddie Mac multifamily MBS in the Proposal.

E. Simplified Supervisory Formula Approach

Under the Standardized Approach NPR, banks may apply the simplified supervisory formula approach ("SSFA") to calculate securitization exposures. The SSFA calculation relies on K_G, the weighted-average of the total capital requirement of the underlying exposures calculated using the Standardized Approach.[42] Other variables in the SSFA, such as W for delinquent loans, further increase the risk weight applicable to a securitized exposure.[43] The Real Estate Associations have several concerns with the proposed SSFA formula, which would substantially reduce liquidity in the real estate markets.

1. *K_G Exacerbates Detrimental Effects of Proposed CRE, HVCRE, and Residential Mortgage Rules*

The proposed SSFA "would require more capital on a transaction-wide basis than would be required if the pool of assets had not been securitized."[44] This proposed treatment of securitizations would further exacerbate the detrimental effects of the proposed residential mortgage and commercial real estate rules. Taking residential mortgages as an example, the proposed residential mortgage rules would reduce the availability and increase the cost of credit by imposing higher capital charges directly on lenders. By incorporating the proposed residential mortgage risk weights in the K_G and other variables that increase the risk weight, the SSFA would impose an even higher capital charge on investors in RMBS than on direct lenders. Because RMBS investors indirectly lend to borrowers and increase liquidity in the residential real estate market, the proposed SSFA rules would further decrease the amount and increase the

[40] *See id.* at 52,915.

[41] *See id.* at 52,907–08.

[42] *Id.* at 52,964 (adding § __.43(b)(1)).

[43] *Id.* at 52,964 (adding § __.44(b)).

[44] *Id.* at 52,919.

cost of available credit. The proposed SSFA similarly would carry through and exacerbate the detrimental effects of the proposed HVCRE rules.

2. *K_G Should Recognize Underlying Asset Quality*

The proposed K_G also is not sufficiently risk sensitive and overstates the risk of securitization exposures because it does not recognize the credit quality of the borrower, the recovery rate, or performance of the underlying asset. Failure to recognize underlying asset quality is especially problematic because the proposed SSFA recognizes external credit enhancements. Credit enhancements cannot be considered in isolation without underlying asset quality; in many instances, credit enhancements compensate for low quality assets. Recognition of one without the other results in perverse and counterintuitive capital requirements. For example, under the proposed SSFA, a securitization with low quality assets—which the proposal does not recognize—and significant credit enhancements—which the proposal does recognize—results in a low risk weight under the SSFA. By contrast, a securitization with high quality assets but no credit enhancements likely results in a higher risk weight, even though such assets do not require credit enhancements precisely because they are high credit quality. The proposed K_G formula thus penalizes banking organizations for investing in higher credit quality transactions. Over time, the lack of risk sensitivity will encourage investment in low quality, higher-yielding assets as well as increase the price of high quality assets to compensate for higher capital requirements.

Ultimately, these capital charges on banking organizations reduce liquidity in the real estate market, reduce the availability of credit for borrowers, and introduce more risk into the system. The proposed formula perversely would provide lower credit-quality borrowers and assets with better treatment than higher credit-quality borrowers and assets. As such, the Agencies should revise the SSFA to incorporate underlying asset quality, performance, and recovery rates in the K_G.

3. *SSFA Potentially Triple Counts Delinquent Exposures*

In addition, the proposed SSFA triple counts delinquent exposures and would worsen economic downturns. The deduction for loan loss reserves[45] and the 150 percent risk weight applicable to past due exposures double-counts the capital requirement for delinquent loans. The proposed SSFA would incorporate this 150 percent risk weight through the K_G, the weighted-average risk weight of the underlying exposures. The SSFA also incorporates a number of variables to increase the risk weight applicable to securitized loans. One of these variables is *W*, which accounts for delinquent loans within a securitized pool.[46] Thus, the proposed capital rules count delinquent loans three times in the overall capital framework: the deduction for loan loss reserves, the 150 percent risk weight for past due exposures and in the K_G calculation, and delinquent exposures in *W*. This approach would require banks to hold more

[45] *Id.* at 52,894.

[46] *Id.* at 52,964 (adding §__.43(b)(2)). The delinquency ratio for *W* is broader than just past due exposures; for example, it also includes exposures subject to bankruptcy or insolvency proceeding, in the process of foreclosure, or held as real estate owned.

capital, and therefore reduce lending, during economic downturns when more borrowers default on their loans. Although delinquent loans are more risky than performing loans, and accordingly deserve higher capital charges, the proposed triple-counting of delinquent securitization exposures would require unnecessarily high levels of capital in the banking system and constrict lending during periods when credit is most needed.

The Real Estate Associations therefore request that the Agencies further study the effects of the SSFA, and particularly the potential triple-counting of delinquent loans, on the real estate sector and the overall economy. Such sweeping changes with potentially drastic effects on the availability and cost of credit should not be implemented without far more empirical support.

X. Conclusion

The Real Estate Associations understand and appreciate the goals that the Agencies are trying to achieve, but we have serious concerns about the impact the proposed rules will have on the commercial and multifamily real estate market, commercial real estate credit flows, and the overall economy. In light of the credit challenges facing commercial real estate, the fragile nature of the economy, and the continued volatility in credit and capital markets, it is important to appropriately craft changes to the existing risk-based capital framework to ensure a properly functioning and reliable credit market.

Given the broad range of concerns among various industry participants regarding the proposed risk-based capital rules, the Real Estate Associations urge the Agencies to carefully study the impact of any proposed rules on the economy and to carefully calibrate risk weights with the actual risk of an asset to avoid perverse lending incentives and regulatory arbitrage. The Real Estate Associations also request the Agencies to re-propose the rule following results from the study and allow public comment period prior to issuing a final rule. These additional steps are necessary to further refine changes to the existing risk-based capital framework and reduce the potential for unintended negative effects on real estate markets and broader economy.

We appreciate this opportunity to comment, and we look forward to working constructively with the Agencies on this important matter.

Sincerely,

Building Owners and Managers Association International

International Council of Shopping Centers

National Apartment Association

National Association of Home Builders

NAIOP, the Commercial Real Estate Development Association

National Association of Real Estate Investment Trusts

National Association of Realtors

National Multi Housing Council

The Real Estate Roundtable

Appendix 1

The Building Owners and Managers Association ("BOMA") International is an international federation of more than 100 local associations and affiliated organizations. Founded in 1907, its 16,500-plus members own or manage more than nine billion square feet of commercial properties. BOMA International's mission is to enhance the human, intellectual and physical assets of the commercial real estate industry through advocacy, education, research, standards and information. Find BOMA online at www.boma.org.

The International Council of Shopping Centers ("ICSC") is the premier global trade association of the shopping center industry. Its more than 55,000 members in over 90 countries include shopping center owners, developers, managers, marketing specialists, investors, retailers and brokers, as well as academics and public officials.

The National Apartment Association ("NAA") is a federation of 170 state and local affiliates comprised of more than 56,000 multifamily housing companies representing more than 6.3 million apartment homes throughout the United States and Canada. Our members are recognized industry leaders who uphold the highest integrity and business practices through our Educational Institute's professional designations. NAA's advocacy initiatives span legislative and regulatory public policy at all levels of government to ensure apartment homes are a national priority.

National Association of Home Builders ("NAHB") is a Washington, D.C.-based trade association whose mission is to enhance the climate for housing and the building industry. Chief among NAHB's goals is providing and expanding opportunities for all people to have safe, decent, and affordable housing. Founded in 1942, NAHB is a federation of more than 800 state and local associations. About one third of NAHB's more than 140,000 members are home builders or remodelers, and its builder members are responsible for about 80 percent of all housing constructed each year in the United States. NAHB members also include for-profit and non-profit builders, developers, owners, and managers represented by the NAHB Multifamily Council, who specialize in the development and management of affordable multifamily rental housing and who participate in the range of federal and state government housing programs.

NAIOP, the Commercial Real Estate Development Association, is the leading organization for developers, owners and related professionals in office, industrial and mixed-use real estate. NAIOP comprises 15,000 members in North America, with over 50 local chapters. NAIOP advances responsible commercial real estate development and advocates for effective public policy.

NAREIT®, the National Association of Real Estate Investment Trusts®, is the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

The 1.1 million members of the National Association of REALTORS® ("NAR") make up America's largest trade association. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,400 local associations or boards, and 54 state and territory associations of REALTORS®.

Based in Washington, DC, the National Multi Housing Council is a national association representing the interests of the larger and most prominent apartment firms in the U.S. NMHC's members are the principal officers of firms engaged in all aspects of the apartment industry, including owners, developers, managers and financiers. One third of Americans rent their housing, and more than 14 percent live in a rental apartment.

The Real Estate Roundtable (www.rer.org) brings together leaders of the nation's top privately-owned and publicly-held real estate ownership, investment, development, lending and management firms with the leaders of the 17 national real estate trade associations to jointly address key national policy issues relating to real estate and the overall economy. Collectively, Roundtable members hold portfolios containing over 5 billion square feet of office, retail and industrial properties valued at more than $1 trillion; over 1.5 million apartment units; and in excess of 1.3 million hotel rooms. The Roundtable's trade association partners represent more than 1.5 million people involved in virtually every aspect of the real estate business.